INVESTMENT COMMENTARY

CARTLIDGE MORLAND

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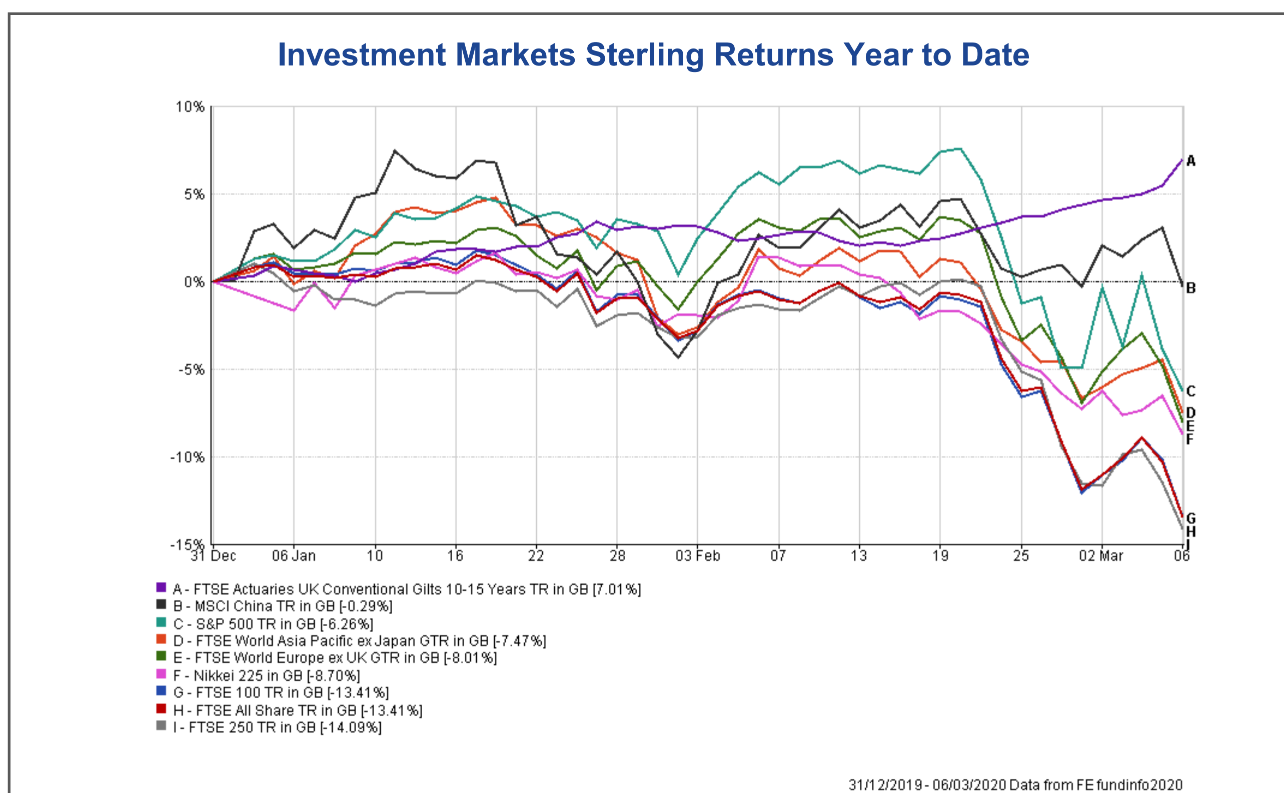
The possible impact of the spread of Coronavirus (Covid-19) has weighed heavily on equity market sentiment over the past few weeks. It would appear that China is now through the worst of its outbreak as thankfully the number of people infected and the mortality rate is dropping. The Chinese equity market is recovering as people return to work and the economy slowly returns to normal. In retrospect, the rest of the world did not take the outbreak sufficiently seriously and it was only towards the end of February that markets fell more steeply than on any occasion since 2008. An investment update was sent to clients at this point. Since then equity markets have been very volatile and are likely to remain so largely based on news flow about infection levels around the world. As we go to press, equity markets have fallen further as a result of OPEC and Russia disagreeing on cutting oil supply to support prices. Saudi Arabia has increased supply in the face of this disagreement sending the oil and equity markets plummeting. Currently, government responses to the virus have varied according to severity of the outbreak but South Korea, Italy and Iran seem the hardest hit, with cities in lockdown. The likelihood is that the position will worsen globally before it improves and the severity and timeframes of the virus are unknown. As would be expected in times of uncertainty, lower risk assets such as government bonds and gold have performed relatively well, as investors seek safe havens. Global economic growth will be lower than expected this year (perhaps even half of the 2.9% growth the Organisation for Economic Co-operation and Development (OECD) had originally estimated for 2020) as countries cope with the outbreak and then restart their economies. Central banks have taken action to loosen monetary policy and governments have pledged monetary support for individuals and companies affected by the outbreak. Such levels of stimulus should be positive for markets at some point.



UK

The UK economy had been showing strong signs of revival with all areas performing better following the more settled political situation. Mortgage approvals had increased to January 2016 levels. Retail sales looked to be recovering to a certain extent. Inflation rose to 1.8% pa as petrol and house prices increased. Average weekly earnings had reached their highest level since the Great Financial Crisis. Business and consumer confidence had improved. The spread of coronavirus coupled with the impact of the extensive flooding are now likely to reverse this more positive outlook, hopefully only in the short term, as the number infected by the virus rise and economic activity falls. Against this uncertain background, the government has embarked on trade negotiations with the European Union and set out its negotiating objectives relating to the US trade deal. The progress of each will have an impact on investor sentiment over the year.

US

Facing an acceleration in the infection rate of coronavirus and a possible slowing of the economy as a result, the US Federal Reserve (Fed) unexpectedly lowered its interest rate range by 0.5% to 1-1.25% after an emergency meeting of its Monetary Committee. The Fed saw signs that the virus was negatively affecting the travel and hospitality sectors, as well as supply chains and posed “evolving risks to economic activity”. Indicators had pointed to solid fundamentals in the US economy with strong job growth in January and retail sales improving, but more recent figures show the economy expanding at a slower rate. The problems in China have disrupted supply chains - particularly in the electronics industry. There may be further interest rate cuts this year if economic growth slows further. The political backdrop with the popularity of the left-leaning Bernie Saunders in the early rounds of the Democratic Party primaries has also weighed on sentiment. The raft of “Super Tuesday” Democratic primaries has seen the campaign of the more moderate Joe Biden reinvigorated, who markets would prefer as the Democratic Party Presidential candidate.

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EUROPE

As coronavirus spreads, the already challenged European economy is likely to weaken still further. Italy has been hardest hit sadly, with a rising infection and mortality rate. Parts of northern Italy and other key areas are now in lockdown as the government seeks to arrest the spread of the virus. Manufacturing and tourism have been badly affected in particular and will continue to be so in the near future. The Italian government is injecting €4.5 bn into its economy with tax credits and additional support of the health service. Prior to the escalation in the outbreak, European economic statistics were looking a little more positive, although the German economy looked to be heading towards recession as factory orders fell steeply – despite business sentiment improving. The European Central Bank (ECB) had thought that the Eurozone economy had stabilised with growth at 0.1% in the final quarter of 2019, but this is now unlikely in the short term as the region copes with coronavirus. The ECB may loosen monetary policy at its next meeting to support the economy although it has limited monetary tools at its disposal.

ASIA PACIFIC

The Chinese authorities now appear to have contained the spread of coronavirus with infection and mortality rates falling. People are returning to work and the challenge is to return to normal production levels and reinstate supply chains as soon as possible. The Chinese equity market has recovered to some extent as a result. The government has halved tariffs on $75bn of US goods which should prove supportive. The Chinese economy has been badly affected with manufacturing indicators at an all-time low and new orders and exports falling dramatically. The services sector suffered its worst month on record in February. The People's Bank of China has cut interest rates to support companies and individuals. There may be less global demand as other countries tackle the virus, so the economy may remain weak. South Korea has also been badly affected by the virus. The government is issuing $13.7bn worth of bonds to support the health service and to provide loans and subsidies to businesses and families. The Japanese economy contracted at an annualised rate of 6.3% in the final quarter of 2019. The increase in consumption tax and the severe typhoon had impacted on growth. The Japanese economy is now likely to be further affected by the spread of coronavirus, with a recession a distinct possibility.

EMERGING MARKETS

The oil price had been hit by the spread of coronavirus as global demand had fallen as economies slowed. The recent move by OPEC to increase supply following a disagreement on pricing with Russia has led to further steep falls in the oil price. The Russian economy had already been hit by the falls and this latest decrease could threaten Mr Putin's spending plans for infrastructure and social projects designed to re-boot economic growth. Coronavirus has also disrupted India's recovery from lower economic growth. In the last quarter of 2019, growth was at a six year low of 4.7% pa. There had been some optimism about economic growth as manufacturing figures improved, but the impact of coronavirus could lead to a cut in the estimated growth rate of 6% pa for the year to March 2020, to 5% pa. The Brazilian economy grew by 1.1% in 2019 and as in India, economic growth forecasts for 2020 were cut to 2.1% pa from 2.3% pa last month. In common with Russia, the strength of the Brazilian economy is strongly influenced by commodity prices, which have fallen as demand has softened. The Brazilian central bank is likely to cut interest rates to support the economy.

COMMERCIAL PROPERTY

Weakness continues in the retail sector as structural changes in the sector continue with increased online shopping impacting on the high street. The fall in visitor numbers to the UK as a result of

COMMERCIAL PROPERTY continued

coronavirus may add further pressure on the sector. The office sector remains stable with slightly stronger capital valuations and rental value growth. The industrial sector remains solid with rental and capital values both rising. The increased certainty following the December General Election saw a rise in transactions in December – 20% of 2019 total commercial property transactions. However, if the UK economy does slow, demand for commercial property across all sectors may soften.

FIXED INTEREST

As would be expected, investor uncertainty in the light of coronavirus has seen bond prices increase as investors have sought safer assets, in particular high grade government bonds. UK gilts and investment grade bonds have performed relatively well and have provided 'portfolio insurance' when equities have fallen in value. Riskier credit assets such as high yield bonds* have lost value as their returns are correlated to equities. Spreads have widened as a result as investors are worried about the companies being able to pay the monthly interest on their bonds. With the Fed making a surprise interest rate cut in the face of coronavirus slowing the economy, yields on ten year US Treasuries (government bonds) have fallen to under 1% for the first time. Further interest rate cuts are expected if the US economy does weaken and perhaps nears recession.

**Most corporate bonds held within CM client portfolios are 'investment grade' rather than 'high yield'. Lower perceived credit quality can affect the price of investment grade corporate bonds, but default by 'investment grade' companies is inherently unlikely. High grade 'investment grade' debt is generally non-correlated with the fortunes of global equity markets.*

OUR VIEW

For the longer term investor, markets have entered an apparently **irrational** period, as a result of which major companies appear to be worth far less in entirety than they were a matter of hours before. A minority may wonder whether they should sell to avert further losses or regret not having done so earlier. All will wonder how much further markets may fall.

Investors may rest assured that those responsible for the immense volume of selling are highly **rational** traders (NOT investors) seeking to profit from extreme market volatility. Their activities and the automated further selling they trigger as lower index thresholds are breached, create the perfect market storm. Whilst uncertainty remains with regard to the spread of COVID-19, the accompanying mortality rate and the effect of preventative measures on global economic activity provide plenty of news flow (positive and negative) to feed a highly elevated level of volatility. It could be that COVID-19 is a cataclysmic event which will wipe out swathes of the World's population and severely depress the global economy for the long-term. In essence, it could be a medical crisis that has a similar effect on financial markets/ economic outlook to the financial crisis just over a decade ago. It **might** be this is the case, but the evidence we have seen from China does not suggest it and our view is therefore based on the expectation that the longer-term overall effects of COVID-19 will be mild, even if it spreads more widely than initially anticipated.

If our view is right, long-term fundamentals will re-assert themselves. Long term investors must stand aside from short term volatility because it will have no discernible effect on the achievement or otherwise of their long-term objectives. Our portfolios remain fully diversified in accordance with the risk levels and investment aims agreed with clients.

We are mindful that steep reductions in asset prices may present our long-term investors with opportunities. We are picking these up as part of our review process but remain mindful of their potential wider application too. We also appreciate that 'appetite for risk' tends to regress during periods of uncertainty and volatility which we are currently experiencing.

This material is not intended to be relied on as a forecast, research or investment advice, and is not a recommendation, offer or solution to buy or sell any securities or to adopt any investment strategy. Cartlidge Morland's current views and suggestions in this document are based on research which is obtained from a variety of sources. Whilst these sources are believed to be reliable, the information obtained cannot be guaranteed to be accurate and may be condensed or incomplete. Past performance is not a guide to the future. The value of investments and income arising may go down as well as up.

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